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Flat taxes and consumption taxes : a guide to the debate;

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EXECUTIVE SUMMARY

Flat Taxes and Consumption Taxes: A Guide to the Debate

Tax Division

DECEMBER 1995



American Institute of Certified Public Accountants 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1081

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PREPARED BY MARTIN A. SULLIVAN

Notice to Readers

This executive summary is a synopsis of the tax practice study *Flat Taxes and Consumption Taxes: A Guide to the Debate*. Such studies are designed as educational and reference material for the members of the Tax Division and others interested in the subject. They do not establish policy positions, standards or preferred practices.

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Introduction

Americans want fundamental tax reform and, more than ever before, the U.S. Congress is inclined to grant their wish. Many proposals now before Congress would entirely eliminate the \$700 billion in annual revenue from the individual and corporate income tax.

To replace this lost revenue, a variety of new tax systems have been proposed. These new taxes come in all shapes and sizes, but they have one common characteristic. They are taxes on *consumption* and, as such, have the potential to improve America's international competitiveness--primarily by increasing private savings. In addition, because entirely new systems are being devised, there is tremendous opportunity for simplification.

No matter how simple the new system, however, the transition to it involves enormously complex political, economic, and technical issues. It is true that most industrialized countries have adopted consumption taxes. But these taxes, for the most part, just served as replacements to poorly functioning excise taxes. No major industrialized country has ever repealed its personal or corporate income taxes.

And nothing in U.S. history can serve as precedent. Such sweeping legislation as the Reagan tax cuts of 1981 and the income tax reforms of 1986 pale in significance compared with the proposals now being floated.

Clearly, as this nation moves closer to fundamental tax reform, it moves deeper into uncharted territory. This AICPA executive summary and the underlying study, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, are designed to help all interested Americans begin to understand how consumption taxes will affect their economy, their businesses, and their own personal finances.

1. The Major Alternatives

There are many types of consumption taxes, but there are four that are critical to understanding the upcoming debate:

- (1) *Retail Sales Tax*.-- Levied by most states and currently favored by House Ways and Means Committee Chairman Bill Archer.
- (2) *Value-Added Tax*.--Levied by every major industrialized country, except the United States and Australia.
- (3) *Flat Tax*.--Proposed by House Majority Leader Dick Armey.
- (4) *Unlimited Savings Allowance (USA) Tax*.--Proposed by Senator Sam Nunn and Senator Pete Domenici.

A. Retail Sales Tax

A Federal retail sales tax at first appears to be an attractive alternative to current law because individuals would no longer file tax returns. A heavy burden would, however, be placed on retailers and tax administrators, particularly if legislators provide exemptions for favored businesses and products.

Even without special exceptions, there are substantial problems, including evasion by small retailers that do not report sales and by business owners that purchase items for personal use. These problems would be particularly severe if a Federal retail sales tax had rates in excess of 20 percent--which would be required to replace revenues lost from the repeal of the income tax.

A retail sales tax also faces the large political hurdles of being a highly visible regressive tax and of encroaching on the states' sales taxes. While a Federal retail sales tax might be administratively feasible as a supplement to the current income tax, it does not seem likely that such a tax would be a good replacement for the current system.

B. Value-Added Tax

Value added is the difference between the value of a business's sales and its purchases from other businesses. A value-added tax is a tax on businesses that is collected as goods move through different stages of production. Most value-added taxes in place throughout the world are *credit-invoice* value-added taxes. These taxes require firms to keep a detailed record of each sale and purchase. In the United States, there is currently little interest in a credit-invoice value-added tax.

One alternative to the credit-invoice method of implementing a VAT is known as the *subtraction* method. The subtraction method is widely considered to be simpler than the credit-invoice method because such taxes may be implemented without new recordkeeping requirements and may instead use existing books and records. The two leading alternatives now being considered for the United States, the Flat Tax and the USA Tax, are variants of a subtraction method VAT.

C. The Flat Tax

The Flat Tax has two components: a business tax and the individual tax. The 17 percent *business* tax is imposed on all businesses, not just corporations. The business tax base is business receipts reduced by (1) wages and (2) purchases from other businesses. Under this new tax, the entire cost of new plant and equipment may be deducted in the first year, and overseas subsidiaries of U.S. businesses are exempt from tax. These advantages to businesses are offset by the loss of deductions for interest payments and for fringe benefits.

Under the *individual* Flat Tax, a 17 percent tax is imposed on wages and pension distributions. Interest, dividends, and capital gains are exempt. Large personal and dependency exemptions would remove tens of millions of taxpayers from the tax rolls. Under proposed Armey legislation, a family of four would only be subject to tax for wages in excess of \$31,000.

Except as described above, the Flat Tax has no other deductions or credits. Most notably, there are no deductions for home mortgage interest, charitable contributions, state income taxes, and property taxes.

It is important to recognize that with a 17 percent rate, a Flat Tax that replaces current income taxes would likely be a large revenue loser. Some economists have argued that a Flat Tax rate of at least 23 percent would be required to avoid revenue losses.

D. The USA Tax

Like the Flat Tax, the USA tax has a business tax and an individual tax. The USA *business* tax has a rate of 11 percent and is imposed on *all* businesses. Also, like the Flat Tax, the entire cost of new plant and equipment may be deducted in the first year and overseas subsidiaries of U.S. businesses are exempt from tax. There are three key differences between the USA and Flat business taxes. Under the USA business tax, (1) the deduction for wages is replaced with a payroll tax credit in the amount of 7.65 percent of most wages, (2) exports are exempt from tax, and (3) an 11 percent duty is imposed on imports.

The USA *individual* tax has graduated rates up to 40 percent. For a family of four the 40 percent rate could apply to incomes as low as \$41,000. Unlike the Flat Tax, there are deductions for charitable contributions and for mortgage interest. There is also a new deduction for income that is saved. In addition, individuals get a 7.65 percent tax credit on most wages.

2. The Big Policy Issues

A. Impact on Saving and Economic Growth

There is no dispute that saving is critical to economic growth. Saving provides the funding for capital formation that gives U.S. workers the tools to be more productive and competitive. There is also no dispute that the U.S. rate of saving is low whether compared with other countries or with past U.S. rates. The replacement of the current U.S. tax system with a consumption tax would increase the after-tax return to capital and would eliminate the bias inherent in the current tax against capital formation.

There is dispute, however, as to how much such tax changes can increase private saving. Even under the most optimistic set of assumptions, it is unlikely that a switch from an income tax to a consumption tax can increase the rate of U.S. saving to a level comparable to that of its major trading partners.

Nevertheless, even modest changes in the rate of saving can have a positive impact on economic growth over the long term. Thus, although there is a high degree of uncertainty, legislation that would replace the current income tax with a consumption tax has significant upside potential from the standpoint of promoting U.S. competitiveness.

B. Balance of Trade

Most consumption tax systems exempt exports and impose tax on imports. (The Flat Tax is an important exception to this rule.) Although these "border tax adjustments" are often perceived as beneficial to a nation's balance of trade, there is broad agreement among economists that these adjustments are unlikely to have any significant impact on trade.

Consumption taxes can, however, improve the trade balance to the extent they are able to increase domestic saving.

C. Redistribution

Consumption taxes are widely perceived as placing an undue burden on the poor and elderly. Any politically realistic consumption tax will likely be supplemented by features to alleviate the burden on low-income households.

Most of the states with retail sales taxes and other countries with value-added taxes exempt necessities such as food, clothing, and health care from the tax base, with the intent of reducing the tax burden on the poor. The exemption of necessities, however, is not particularly effective in mitigating the regressivity of consumption taxes.

Some form of tax credit or standard deduction will likely play an important role in alleviating the regressivity of any new consumption tax enacted into law.

D. Simplification

The proposed new consumption taxes have tremendous potential for simplification. This is particularly true because under the proposals some of the more complex areas of current law--namely the tax treatment of pensions, of international income, and of corporate acquisitions--become obsolete.

New tax systems, however, may entail new compliance requirements that add complexity. For example, the USA Tax must have complicated rules to determine “new” saving that is eligible for deductions, and under the Flat Tax, businesses must be able to differentiate between business expenses (which are deductible) and fringe benefits (which are not deductible).

In addition, much of the complexity of the current tax Code is attributable to dozens of targeted tax benefits. Proposed tax laws often appear simpler than existing taxes because existing law has been subject to successive legislative amendments that add complexity. It is highly probable that any new consumption tax would accrete substantial complexity (at the outset as well as in subsequent legislation) as Congress found it necessary to provide tax relief for a variety of taxpayers. Finally, there will be costs to government and taxpayers of transitioning from one system to another.

E. Transition

Without special transition rules, the replacement of an income tax with a consumption tax would haphazardly subject many individuals and businesses to large tax penalties. In the absence of transition relief, saving and investment done prior to enactment would have to pay significantly higher tax than under prior law. (In contrast, new saving and investment would be tax-free.) These retroactive tax increases would unfairly burden not only elderly individuals who are no longer saving, but also mature businesses that are no longer investing. In addition, without adequate transition relief, tax reform proposals could have a large and significant impact on the financial statements of many firms.

Transition relief is expensive both in terms of lost revenue and in terms of administrative and compliance costs.

F. Inflation

A consumption tax is unlikely to have any sustained impact on the rate of inflation. There may, however, be a one-time impact on the overall price level if the Federal Reserve responds to the tax change with an expansion of the money supply.

3. The Impacts on Different Types of Businesses

A. Corporate Businesses

In general, under both the Flat Tax and the USA Tax, labor-intensive firms--such as those in the construction, service, and transportation sectors--bear a greater share of the total corporate tax burden than they would under the current corporate income tax. Capital-intensive industries--like those in the communications and public utilities sectors--are likely to pay less taxes.

The exclusion of exports from gross receipts provides large tax benefits to those firms that export. For a typical manufacturing exporter, the exclusion of exports available under the USA Tax can easily cut a business's tax liability in half. In contrast, the Flat Tax does not exempt exports.

B. Noncorporate Businesses

Both the USA proposal and the Flat Tax impose new tax burdens on noncorporate businesses. For a "typical" small business, the USA Tax imposes a greater business tax burden than the Flat Tax.

One way of assessing the impact on noncorporate business is to compare the combined individual and business tax burdens before and after the imposition of a new consumption tax. The combined burden for the owners of unincorporated businesses under the Flat Tax appears to be less than under current law. In contrast, the total tax burden under the USA Tax appears to be greater than current law, particularly for high-income owners of unincorporated businesses whose compensation would be subject to a combined business and individual tax rate in excess of 50 percent

4. The Impact on Individuals

Relative to current law, the USA Tax generally provides tax relief to low- and high-income taxpayers, and a modest tax increase to middle-income taxpayers.

The Flat Tax appears to provide tax relief to nearly all individual taxpayers (except those low-income households receiving refunds under current law from the earned income tax credit). This tax relief is particularly large for high-income taxpayers because interest, dividends, and capital gains are exempt from tax.

5. Some Important Details

A. Housing

In most other countries with consumption taxes, new housing is subject to tax and existing housing is exempt. Under both the USA Tax and the Flat Tax, new residential construction is subject to business tax.

Under the individual Flat Tax, the elimination of the deduction for mortgage interest (along with the loss of deductions for property taxes) adversely affects homeowners. Under the individual USA Tax, which allows deductions for mortgage interest, housing continues to enjoy its tax-favored status.

B. Banking, Insurance, and Other Financial Service Providers

Because it is difficult to identify and value services provided by financial institutions, no other country with a consumption tax has been able to properly tax financial services. Any rules that can be devised to include financial services in a new U.S. consumption tax are likely to be extremely complex and--if not carefully formulated--could significantly impact the competitive balance among various financial service providers.

C. State and Local Governments

State and local governments could suffer financial hardship if their taxes are not deductible against Federal tax--as is the case under both the Flat Tax and the USA Tax. In addition, a new Federal consumption tax might encroach on the states' ability to levy their own sales taxes. Repeal of the Federal income tax will surely complicate administration of state income taxes.

D. Charitable Organizations

Under some tax reform proposals, donors to charitable organizations lose the benefit of deductions for contributions, and the charitable organizations themselves are liable for tax on their activities.

E. Estate and Gift Taxation

It is an open question whether estate and gift taxes would be retained or repealed under any tax reform proposal enacted into law. The Arney Flat Tax repeals estate and gift taxes. The USA Tax retains the current estate and gift tax structure. (The USA Tax also amends current law by replacing tax-free step-up basis with carryover basis at death.)

Conclusion

As much as lawmakers may want to satisfy the public's desire to eliminate the income tax and replace it with a simple tax, there are no easy solutions.

There are unresolved questions concerning the impact of these tax changes on saving, productivity, trade, interest rates, and inflation. There is debate about the compliance and administrative costs of these new proposals and about the amount of revenue they raise. There are a host of unresolved technical issues--transition relief, banking and financial products, and housing.

Finally, there are numerous political issues that have not even yet begun to sort themselves out because so few taxpayers understand the impacts of the proposed new taxes. There is, of course, the age-old issue of rich versus poor. And, if that were not enough, politicians must still address concerns surrounding redistribution of the tax burden from the young to the elderly, from low-tax to high-tax states, from capital-intensive to labor-intensive industries, from exporters to importers, and from corporate to noncorporate businesses.

